



January 4, 2006

Ms Lucinda A. Ehnes, Director
California Department of Managed Health Care
980 Ninth Street, Suite 500
Sacramento, CA 95814

Dear Ms. Ehnes:

Final Report: California Department of Managed Health Care—Internal Control Review

Enclosed is our final internal control report on the California Department of Managed Health Care (Department) as of March 7, 2005. The Department of Finance (Finance), Office of State Audits and Evaluations, performed this review in accordance with the Financial Integrity and State Managers Accountability Act of 1983, Government Code Section 13400 et seq.

In accordance with the Department of Finance's policy of increased transparency, the final report will be placed on Finance's website. We appreciate the assistance and cooperation of Department staff and management during our review. If you have any questions, please contact Diana Antony, Manager, at (916) 322-2985.

Sincerely,

Original signed by Diana L. Ducay

Diana L. Ducay, Chief
Office of State Audits and Evaluations
(916) 322-2985

Enclosure

cc: Mr. G. Lewis Chartrand, Chief Deputy Director, California Department of Managed Health Care
Mr. Kip Gilbert, Assistant Deputy Director, Office of Administrative Services, California Department of Managed Health Care

AN INTERNAL CONTROL REVIEW

California Department of Managed Health Care

Prepared By:
Office of State Audits and Evaluations
Department of Finance

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The primary responsibility of the California Department of Managed Health Care (Department) is to help California consumers resolve problems with their Health Maintenance Organizations (HMOs) also known as “Health Plans” and ensure a better, more solvent and managed health care system. The Department licenses and regulates California HMOs through the authority of the Knox-Keene Health Services Plan Act (Knox-Keene Act) and provides HMO oversight through financial examinations and medical surveys. In addition, the Department develops legislation to address emerging consumer and industry issues.

Department management is responsible for the establishment and maintenance of internal accounting and administrative controls. These controls are defined as a process to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations. This definition includes five interrelated components:

- *Control environment* sets the tone of an organization, influencing the control consciousness of its staff. It is the foundation for all other components of internal control, providing discipline and structure.
- *Risk assessment* is the entity’s identification and analysis of relevant risks to the achievement of its objectives, forming a basis for determining how the risks should be managed.
- *Control activities* are the policies and procedures that help ensure management directives are carried out.
- *Information and communication* are the identification, capture, and exchange of information in a form and time frame that enable staff to carry out their responsibilities.
- *Monitoring* is the process that assesses the quality of internal control performance over time.

The objective of our internal control review was to assist the Department in complying with the Financial Integrity and State Managers Accountability Act of 1983. Specifically, we assisted the Department in determining whether: (1) assets are safeguarded from unauthorized use or disposition, (2) financial transactions are executed in accordance with management’s authorizations and recorded properly to permit the preparation of reliable financial statements, and (3) financial operations are conducted in accordance with State Administrative Manual guidelines, and certain other state laws and regulations, as well as the Department’s policies and procedures.

Our review did not include an evaluation of the efficiency or effectiveness of the Department's operations, or the accomplishment of program goals or objectives.

This report is intended for the information and use of the Department and should not be used for any other purpose. However, the report is a matter of public record and its distribution is not limited.

STAFF:

Diana Antony, CPA
Manager

Karis Feldkamp, CPA
Supervisor

Kweku Atta-Mensah
Daniel Solheim
Jared Engelbrecht

EXECUTIVE SUMMARY

During our review of the Department of Managed Health Care's (Department) internal control, we identified several areas where controls were in place and working as intended. We also identified areas where controls could be improved to reduce the risk of errors, irregularities, and material misstatements. Our findings and observations are summarized below. For further analysis refer to the Findings and Recommendations section of this report.

Administrative Controls: The Department's documentation of policies and procedures is sufficient to ensure proper control and accountability over its operations.

Information Technology: The Department's internal controls over information technology, specifically related to fiscal and accounting functions, appear adequate to ensure the reliability and integrity of data. However, we observed inadequate password protection of unattended workstations. See the Findings and Recommendations section for further analysis.

Budget: The Department's internal controls over its budget functions appear adequate to ensure the reliability and integrity of data. The Budget Office maintains current policies and procedures and records appropriations timely. Our tests of controls indicated no reportable conditions.

Cash Receipts: The Department's internal controls over cash receipts appear adequate to ensure the collection of receipts, safeguarding of receipts prior to deposit, and prompt and proper recording in the accounting records. However, our tests of controls indicated inadequate separation of duties over cash receipts. See the Findings and Recommendations section for further analysis.

Receivables: The Department's internal controls over receivables are sufficient to ensure the reliability and integrity of data. However, we observed late billings, and inadequately documented collection efforts. See the Findings and Recommendations section for further analysis.

Purchasing: The Department's internal controls over purchasing are sufficient to ensure that purchases of goods and services are properly authorized and made in accordance with state policies. However, we observed that the accounting unit is not timely notified of goods received. See the Findings and Recommendations section for further analysis.

Cash Disbursements: The Department's internal controls over cash disbursements are sufficient to ensure that cash disbursements are properly authorized and made only for allowable purposes. However, we noted that bank reconciliations are not performed timely and the canceled checks are not delivered directly to the employee responsible for reconciling bank accounts. See the Findings and Recommendations section for further analysis.

Revolving Fund: The Department's internal controls over its revolving fund are sufficient to appropriately safeguard state assets. However, we noted inadequate monitoring over a petty cash fund. See the Findings and Recommendations section for further analysis.

Personnel/Payroll: The Department's controls over the personnel and payroll functions are sufficient to ensure the reliability and integrity of data. The Department's employee appointments appear adequate and the separation of duties over personnel and payroll transactions is adequate. However, we observed a lack of documentation for separating employees. See the Findings and Recommendations section for further analysis.

Contracts: The Department's internal controls over contracting are sufficient to ensure that contracts are accompanied by the required supporting documents and are adequately monitored to ensure compliance with contract provisions, competitive bidding requirements are properly followed, the splitting of contracts is avoided, payment on contracts is not made prior to contract approval, adequate monitoring and/or inspection is performed on contracts requiring periodic payments, modifications or amendments are proper, and all required reports are completed and filed with the Department of General Services. Our tests of controls indicated no reportable conditions.

Fixed Assets: The Department's internal controls over fixed assets are sufficient to ensure that acquisitions are properly approved, classified, and timely posted. However, our tests of controls indicated incomplete documentation of desk procedures and inadequate recording of acquisition dates on the property ledger. See the Findings and Recommendations section for further analysis.

Financial Reporting: The Department's financial reporting controls appear adequate. We observed that the required financial statements are properly prepared, certified, and submitted timely; and that required supporting documentation is available. Our tests of controls indicated no reportable conditions.

This report is intended to assist Department management in focusing attention on areas of risk and in strengthening internal control and improving operations.



AUDITOR'S REPORT

Ms. Lucinda A. Ehnes, Director
California Department of Managed Health Care
980 Ninth Street
Sacramento, CA 95814

We have reviewed the California Department of Managed Health Care's (Department) internal control as of March 7, 2005, for conformity with Government Code Section 13400 et seq. Our review included obtaining an understanding of the internal control through observations and interviews, testing and evaluating the design and operating effectiveness of the Department's internal control, and performing other procedures we considered necessary.

Department management is responsible for establishing and maintaining adequate internal control. This responsibility, in accordance with Government Code Section 13400 et seq., includes documenting internal control, communicating requirements to employees, and assuring that the internal control is functioning as prescribed. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of internal control are to provide reasonable, but not absolute, assurance that:

- Assets are safeguarded against loss from unauthorized use or disposition.
- Transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of reliable financial statements.
- Financial operations are conducted in accordance with policies and procedures established in the State Administrative Manual.

Because of inherent limitations in internal control, misstatements due to error or fraud may occur and not be detected. Also, projection of any evaluation of internal control to future periods is subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with policies or procedures may deteriorate.

In reviewing the Department's internal control in effect as of March 7, 2005, we noted certain matters involving the internal control and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control that, in our judgment, could adversely affect the Department's ability to record, process, summarize, and report financial

data consistent with the assertions of management in the financial statements. These reportable conditions are described in the *Findings and Recommendations* section of this report.

A material weakness is a condition that precludes the Department's internal control from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected timely. We believe that none of the reportable conditions are material weaknesses.

This report is intended solely for the information and use of Department management and is not intended to be and should not be used by anyone other than this specified party. However, this report is a matter of public record and its distribution is not limited.

Original signed by Diana L. Ducay

Diana L. Ducay, Chief
Office of State Audits and Evaluations

March 7, 2005

FINDINGS AND RECOMMENDATIONS

During our review of the Department of Managed Health Care's (Department) internal control as of March 7, 2005, we noted that many controls were functioning as intended. However, we also identified areas where controls are not in place and where corrective action is necessary, as described below.

Purchasing

Effective internal control over purchasing is necessary to ensure that the Department acquires only those goods and services that are authorized and necessary for effective operations. We noted the following weakness in the controls over purchasing.

FINDING 1 Untimely Notification of Goods Received

- Condition: Individual units within the Department use their own procedures for the receipt of goods and do not send any form of receipt notification to the accounting unit on the day goods are received. Although the accounting unit forwards the vendor invoice to individual units for receipt verification, this could occur from 10 to over 60 days after goods are received. As a result, the accounting unit is not timely notified of goods received. Untimely evidence of receipt and approval decreases accountability over state assets and increases the risk of loss.
- Criteria: State Administrative Manual (SAM) Section 8422.20 states that the original stock received report, or signed copy of the order used as a stock received report, is to be forwarded directly to the accounting office on the day the goods are received. These documents provide the accounting officer with information as to the identity, condition, and net quantities of goods received.
- Recommendation: Ensure that all purchases are noted by the receiving personnel with the notification forwarded to the accounting unit the day the goods were received.

Fixed Assets

Departments are required to implement internal controls to safeguard property, plant, and equipment from unauthorized acquisition, use, or disposition. We identified the following weaknesses in the Department's property controls.

FINDING 2

Incomplete Documentation of Fixed Asset Procedures

Condition:	<p>The fixed asset policies and procedures are incomplete and lack management approval. Specifically, although the procedures include the process for acquiring equipment, they do not include the process of, (1) recording acquisition dates in the fixed asset system, (2) equipment disposition, or (3) reconciliation of the fixed asset subsidiary ledger with the general ledger. Several assets on the property ledger, including recent acquisitions, do not include acquisition dates. Of 85 assets over \$5,000 reviewed, 16, or 19 percent, did not have acquisition dates. In addition, although the Department completes disposition procedures adequately and performs quarterly reconciliations, it does not have adequate written procedures to guide staff in the implementation of SAM fixed asset requirements. Failure to adequately document and maintain current policies and procedures increases the risk of inconsistencies and errors within operational processes and diminishes the Department's training effectiveness should a turnover in staff occur.</p>
Criteria:	<p>SAM Section 20050 states that a satisfactory system of internal control shall include a system of authorization and recordkeeping procedures adequate to provide effective accounting and administrative control.</p> <p>SAM Section 8600 requires accurate accounting records to protect state property and SAM Section 8650 states that Departments will record the property acquisition date.</p> <p>SAM Section 7821 requires departments to maintain a property register that is subsidiary to the general ledger and SAM Section 7800 requires this register to be reconciled monthly to the general ledger.</p>
Recommendation:	<p>Draft, approve, and disseminate complete written procedures governing implementation of applicable SAM requirements. Specifically include procedures over acquisition dates, equipment dispositions, and reconciliations.</p>

Receivables

The Department records receivables for annual assessments, independent medical reviews, fines and penalties, licenses, and fees. Effective internal controls over receivables are necessary to ensure that all amounts due the Department are collected and promptly recorded. We identified the following receivable weakness.

FINDING 3

Inadequate Application and Documentation of Collection Procedures

Condition:	<p>The Department's procedures do not ensure prompt and systematic application of collection procedures in cases of delinquent receivables. Specifically, 17 out of 24, or 71 percent, of the collection letters reviewed were mailed after the 30 day interval. For example, the first notice for a \$34,000 receivable was sent over six months after the due date. In addition, the Department does not adequately maintain records of</p>
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receivables written off and does not adequately document its efforts to collect delinquent receivables. We note that in cases where debtors file for bankruptcy, there is no documentation of the efforts to work with the bankruptcy courts.

Criteria: SAM Section 8776.6 requires each department to develop collection procedures to assure prompt follow up, and lists the required procedures and guidelines for departments to use.

Recommendation: Ensure consistent monitoring of the accounts receivable and train staff on the need to send collection letters at 30 day intervals. In addition, update accounts receivable procedures, specifically including policies over write-offs and documentation of collection efforts.

Information Security

Effective internal control over information data and technology is necessary to ensure data integrity and adequate prevention against unauthorized access. We identified the following weaknesses in the Department's internal control over information security.

FINDING 4 Inadequate Password Protection

Condition: The Department needs to enforce the use of password protection at individual workstations. Although access is restricted to the accounting staff, none of the ten workstations observed were password protected. Six of the ten workstations were unattended and one of the workstations had a spreadsheet with sensitive data on display.

Criteria: SAM Section 4841 requires each agency to provide for the proper use and protection of its information assets including the integrity and security of automated information.

Recommendation: Ensure users password protect their unattended workstations.

Cash Disbursements

Cash is the asset most vulnerable to misappropriation. As such, the Department must ensure that its controls are adequate to safeguard cash and to prevent and timely detect any errors or misappropriations. We identified the following weaknesses in the Department's internal control over cash disbursements.

FINDING 5 Untimely Reconciliation of Bank Accounts

Condition: Bank reconciliations are not completed timely. Specifically, the July and October 2004 bank reconciliations were completed in 58 and 51 days, respectively. In addition, canceled checks are delivered to an employee other than the employee responsible for bank reconciliations. Canceled checks should be delivered directly to the employee responsible for reconciling bank accounts.

Criteria: SAM Section 7901 requires all reconciliations be completed within 30 days of the preceding month.

SAM Section 8080 requires paid checks be delivered unopened to the person performing the bank reconciliations for safekeeping until the reconciliation is completed.

Recommendation: Ensure reconciliations are completed within 30 days of the preceding month. In addition, ensure canceled checks are directly delivered to the employee responsible for the bank reconciliations.

Personnel/Payroll

Effective internal control over the personnel and payroll functions is required to ensure that Department staff is properly appointed, staff is not separated with outstanding advances or in possession of Department assets, and payroll information is processed accurately and timely. We noted the following weakness in the controls over personnel and payroll.

FINDING 6 Incomplete Documentation for Separating Employees

Condition: The Department is not consistently completing employee clearance forms. The clearance forms provide a method for: (1) clearing outstanding advances made to the separating employee, and (2) collecting state property assigned to the employee. The Department did not complete a separation package for three out of five separating employees reviewed.

Criteria: SAM Section 8580.4 states that salary warrants will not be distributed to terminating employees until the agency is assured that all outstanding travel and salary advances have been paid.

Recommendation: Ensure all separating employees complete employee clearance forms.

Cash Receipts

Effective internal control over cash receipts is necessary to ensure amounts collected are proper and authorized, adequately controlled upon receipt, deposited intact or are otherwise adequately safeguarded, remitted to the State Treasurer's Office promptly for maximization of interest earnings to the Department. We observed the following weakness in the Department's internal control over cash receipts.

FINDING 7 Inadequate Segregation of Duties

Condition: The Department's procedures do not ensure adequate separation of duties over cash receipts. Specifically, the cashier receives and deposits remittances as well as prepares checks.

Criteria: SAM Section 8080 states that no one person will perform more than one of the following types of duties:

- Receiving and depositing remittances.
- Preparing checks

Government Code 13403 states, "The elements of a satisfactory system of internal accounting and administrative controls, shall include, but are not limited to a plan of organization that provides segregation appropriate for proper safeguarding of state assets."

Recommendations: Ensure adequate accounting duty separations as required and feasible.

Revolving Fund

Effective internal control over the revolving fund is necessary to ensure amounts advanced to the fund are proper and authorized, adequately controlled, and commensurate with the needs of the Department. We observed the following weakness in the Department's internal control over the revolving fund.

FINDING 8 Inadequate Monitoring of Petty Cash

Condition: The \$100 petty cash fund maintained at the Director's office is not reimbursed monthly, disbursements are not logged, and the fund was short \$20. In addition, the fund was used for inappropriate purposes (travel).

Criteria: SAM Section 8112.5 requires custodians of the petty cash fund to present invoices at least once a month to replenish the cash purchase fund.

The Department's procedure manual requires that a log be maintained of cash disbursed and prevents the use of the fund for travel expense.

Recommendation: Ensure disbursements are used for authorized purposes only, log transactions at the time of each disbursement, reconcile, review, and reimburse the fund monthly.

CONCLUSION

Our review of the California Department of Managed Health Care's (Department) internal control presents opportunities for Department management to correct identified weaknesses and improve its operations. We believe internal controls would be strengthened and the Department would operate more effectively if management implements our recommendations. The internal control weaknesses, if left uncorrected, increase the risk that material errors or irregularities could occur and remain undetected, and could adversely affect the Department's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

The findings in this report are based on fieldwork performed between January 27, 2005 and March 7, 2005. We presented our findings and observations to the related units and Department management throughout our fieldwork.

DEPARTMENT'S RESPONSE



December 21, 2005

Ms. Janet I. Rosman, Assistant Chief
Office of State Audits and Evaluations
300 Capitol Mall, Suite 300
Sacramento, CA 95814

Dear Ms. Rosman:

Response to Draft Report: California Department of Managed Health Care - Internal Control Review

Thank you for the opportunity to respond to the draft report on internal controls for the Department of Managed Health Care (DMHC) completed on March 7, 2005. We appreciate the time and effort your staff took to review the internal controls we have in place. The thoroughness of their review, and the relatively minor findings, was a testimonial to the priority we have placed on maintaining proper internal controls.

As you may know, the Department was established July 1, 2000. Part of the new organization and corresponding positions, came from the Department of Corporations, while the majority of the structure and positions were new and reflected the redefined role of DMHC in regulating HMO's. We basically began with a "clean slate" in terms of established business processes, and staff worked hard to meet the demands of launching the new department and setting into place, appropriate internal control systems.

To evaluate our success in doing this, and identify any areas of risk, in early 2002 we contracted for the services of Arnold Schuler, a C.P.A and respected, former state executive. Mr. Schuler performed an extensive review of our internal control systems department wide and although no major vulnerabilities were discovered, areas of improvement were identified. Since that initial review, Mr. Schuler has been retained to periodically re-visit key internal control areas, and assisted throughout your staff's audit. In fact, his findings and the Department's responses we are told were extremely helpful to your auditors.

The Department's response to the audit findings can be found on the attached document. As you can see, we have already implemented actions to address each finding.

ARNOLD SCHWARZENEGGER
GOVERNOR

BUSINESS,
TRANSPORTATION
AND HOUSING
AGENCY

DEPARTMENT OF MANAGED HEALTH CARE

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Again, thank you for your audit of the department's internal controls. Your review will only enhance the department's efforts and our continuing commitment to safeguard our assets in meeting the requirements of the Financial Integrity and State Managers Accountability Act of 1983.

If you or your staff has any additional questions, please contact Naomi Yoshihara at (916) 324-5195.

Sincerely,

Original signed by Lucinda A. Ehnes

Lucinda A. Ehnes, Director
California Department of Managed Health Care

Enclosure

RESPONSES

FINDING 1 Untimely Notification of Goods Received

The Department of Managed Health Care will require staff to submit a signed copy of the purchase document, (STD65, STD66, STD 67, etc.) showing items received to the Accounting office the day the items are received.

FINDING 2 Incomplete Documentation of Fixed Asset Procedures

Although the Department currently has written fixed asset procedures in place, they are not as comprehensive as the audit finding recommends. A change in the written procedures will be released by December 30, 2005, to fully address the audit issues.

FINDING 3 Inadequate Application and Documentation of Collection Procedures

All outstanding accounts receivables are now monitored in a spreadsheet log. This spreadsheet log monitors the 30-day follow-ups of outstanding receivables as well as monitors Enforcement actions taken on monthly bases. The accounts receivable procedures have been updated to reflect revisions to the accounts receivable process, write offs and documentation of collections.

FINDING 4 Inadequate Password Protection

Even though access to the Accounting office is restricted to accounting staff only, we do understand the importance of protecting information at our workstations. We have implemented mandatory password protection on workstations when staff leaves their work area. Also, the Accounting Manager constantly reminds staff and periodically checks workstations to ensure password protection is implemented on unattended workstations.

FINDING 5 Untimely Reconciliation of Bank Accounts

The bank reconciliations for two of the 12 months reviewed weren't completed timely due to staffing limitations. To ensure timely reconciliation in the future, a back up person has been trained to perform bank reconciliations.

Canceled checks are now delivered directly to the employee responsible for reconciling the bank accounts. This employee makes sure all canceled checks are accounted for before other staff members can view checks.

FINDING 6 Incomplete Documentation for Separating Employee

It appears the employee separations reviewed were separated prior to the implementation of a department-wide online separating employee process. The department developed a comprehensive online employee separation process that was implemented in May 2004.

The process consists of the office liaison submitting an online form announcing the upcoming separation of an employee. This submission triggers online notices to be sent to all units involved in the clearance of a separating employee (employee, supervisor, Accounting, Human Resources, Business Management, and the Office of Technology and Innovation). This process ensures appropriate notifications so that separating employees are not overpaid or allow to be paid without collection of accounts receivable, travel and/or salary advances.

FINDING 7 Inadequate Segregation of Duties

We have removed the check preparation from the duties of the person who receives and deposits remittances.

FINDING 8 Inadequate Monitoring of Petty Cash

We have revised procedures. We have set up a monthly electronic calendar reminder to ensure

timely submittal of month end logs.
Reimbursements are processed the month after
transactions occur.